A recipe for trade reform

A new study by the World Bank has analysed almost every big programme of trade reform undertaken by third-world governments during the past 40 years. It suggests that following a few simple rules virtually guarantees success

ECONOMICS FOCUS

FOR many years economists have argued about the best way to promote growth in developing countries. Is it better to encourage trade, exposing domestic producers to foreign competition; or to discourage it, shielding producers until they can compete? In the third world, at least, the argument is just about settled. Liberal traders such as Hongkong, Taiwan, South Korea and Singapore have achieved startling rates of growth. Followers of the protectionist model—including, until recently, Mexico, Brazil and Argentina—have grown far more slowly. The issue is no longer whether to open such economies to trade, but how.

Until now, this question has received relatively little attention. A new study* by the World Bank fills the gap. It looks in detail at 36 trade-reform programmes in 19 countries. The sample includes New Zealand and one or two other non-poor countries—but its great virtue is that it looks at virtually every substantial attempt that third-world governments made between 1945 and 1984 to reform their trade policies.

The Bank's economists conclude that 15 of the programmes "succeeded"—ie, the governments persevered with them. Of the others, nine were partially reversed and 12 collapsed. Our table lists 13 of the 15 successful programmes (some information was lacking for the other two). Then it asks four questions of each:

- Did the programme substantially move away from **quotas** as a way of controlling imports? Quotas are an especially damaging form of protection. Like tariffs, they distort prices; unlike tariffs, they allow foreigners to collect the implicit tax on consumers (so-called quota rents). Eliminating quotas, even if only to replace them with tariffs, is item number one on the blueprint of most trade economists.
- Was the programme **strong or weak**? Adopting a strong programme (one that starts with a bang, and then follows through with other measures) might seem as desirable as abolishing quotas. Perhaps not. If the transitional costs of radical changes are high, the reform might fail for lack of political support. Timidity (call it gradualism to be polite) may work better.
- Did the reform include a substantial **devaluation** of the currency? Many would-be reformers start their programmes with a combination of high inflation and a pegged exchange rate; their currencies are often overvalued as a result. With imports thus artificially cheap (and exports artificially dear), freer trade may cause balance-of-payments difficulties. An early currency devaluation ought to help.
- Was **fiscal policy** tight, neutral or loose? This ties in with the previous question. If a country is struggling with high inflation and declining competitiveness, trade reforms may prove impossible to sustain. In most developing countries, therefore, better control of inflation will help trade reform to work. This, in turn, often requires a tightening of fiscal policy.

The table makes it clear that no single element or combination of elements is strictly necessary for success. Some programmes lasted despite one or more of the following: no reform of quotas, weak measures, no devaluation and loose fiscal policy. However, the evidence suggests that these policies are usually mistaken. Eight of the 13 successful programmes in the table (62%) included a substantial reform of quotas; nine (69%) were classified as strong; seven (54%) incorporated a big devaluation; and 12 (92%) kept fiscal policy either tight or neutral.

None of these four characteristics may be absolutely necessary for success, but one of them by itself seems to be almost sufficient: reform of import quotas. Of the full sample of 36 programmes, 11 involved a big reform of quotas. Nine of these 11 succeeded—and the other two were only partially reversed. Look at it this way: no programme that tackled quotas in a serious way failed outright. This is the study's single most striking result.

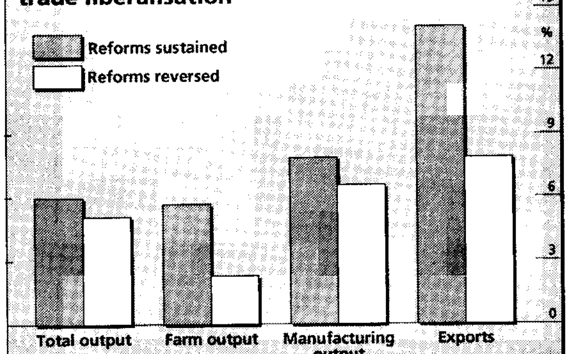
However, before reforming quotas alone, governments should note that every one of those 11 quota-reforming programmes was also strong, and almost all involved a devaluation and avoided loose fiscal policy. In other words, the sample offers no information about programmes that tackle quotas and stop at that. To be on the safe side, therefore, governments need to do all four things: reform quotas, be bold, devalue the currency and keep fiscal policy tight. This appears to be the recipe for success.

The chart answers any fears there might be that successful reform has unpleasant side-effects. For instance, it is sometimes argued that trade liberalisation causes growth to slow for a few years while the economy adjusts to the new pattern of relative prices. The chart shows average growth in various measures of output—total, agricultural, manufacturing and exported—over the first four years of reform, comparing the programmes that lasted with the ones that were quickly reversed. On every measure, sustained reform produced better results. So the study not only shows how reforms can be made to stick; it also confirms that, when they do, they work.

Trade reform in developing countries

	Substantial reform of quota restrictions?	Strong programme or weak?	Big devaluation?	Fiscal policy tight, neutral or loose?
Chile 1974-81	Yes	Strong	Yes	Tight
Greece 1953-55	Yes	Strong	Yes	Tight
Indonesia 1966-72	Yes	Strong	Yes	Tight
Israel 1952-55	Yes	Strong	Yes	Tight
Israel 1962-68	Yes	Strong	Yes	Loose
Israel 1969-77	No	Strong	No	Tight
S.Korea 1965-67	No	Weak	No	Neutral
S.Korea 1978-79	No	Weak	No	Neutral
N.Zealand 1962-81	No	Weak	No	Neutral
N.Zealand 1982-84	No	Weak	No	Neutral
Singapore 1968-73	Yes	Strong	No	Neutral
Sri Lanka 1977-79	Yes	Strong	Yes	Tight
Turkey 1980-84	Yes	Strong	Yes	Tight

Annual average growth in four years after trade liberalisation



Source: World Bank

* The full seven-volume study is "Liberalising Foreign Trade", edited by Demetrios Papageorgiou, Armeane Choksi and Michael Michaely, published by Basil Blackwell. A World Bank pamphlet, "Liberalising Foreign Trade in Developing Countries: the Lessons of Experience", summarises the results.